



**STATE BOARD OF EQUALIZATION
STAFF LEGISLATIVE BILL ANALYSIS**

Date Amended:	04/13/04	Bill No:	AB 2546
Tax:	Sales and Use Tax, Bradley-Burns Tax, and Transactions and Use Tax	Author:	Lowenthal
Board Position:		Related Bills:	

BILL SUMMARY

This bill would authorize any city, county, or city and county (city or county) to conduct an examination of the books and records of any person selling tangible personal property or any person liable for the use tax within the jurisdiction of the city or county, and allow that city or county to be compensated in an amount equal to 25 percent of all taxes collected by the Board of Equalization (BOE) from such activities

Summary of Amendments

The amendments to this bill would do the following: (1) authorize a city or county to conduct examinations only (the introduced version of the bill allowed cities and counties to conduct examinations, investigations, or audits, or all three); (2) delete the language that would reimburse a city or county for an amount not less than 25 percent of all taxes collected, as a result of the city's or county's examination, and instead provides that the BOE shall compensate the city or county in an amount equal to 25 percent of the sales and use taxes collected by the BOE pursuant to findings or recommendations received from the city or county; (4) prohibits a city or county from conducting an examination under specified circumstances; (5) allows a city or county to conduct an examination of any person selling tangible personal property or any person liable for the use tax, whether or not that person is registered with the BOE; (6) allows a city or county to contract with a private auditing firm to conduct an examination; (7) provides that a city or county upon completion of its examination shall notify the BOE of its findings and recommendations; and (8) prohibits a city or county from performing any postexamination functions, including but not limited to, issuing a determination, hearing a petition, considering a claim for refund, settling a tax liability, or collecting a tax liability.

ANALYSIS

Current Law

Section 7054 of the Sales and Use Tax Law provides that the BOE may authorize the examination of the books, papers, records, and equipment of any person selling tangible personal property or any person liable for the use tax on the purchase of tangible personal property. Section 7056 of the Sales and Use Tax Law provides

This staff analysis is provided to address various administrative, cost, revenue and policy issues; it is not to be construed to reflect or suggest the Board's formal position.

that a city, county, city and county, or special district wishing to examine the BOE records to verify that transactions subject to sales or transactions and use tax have been reported properly, must adopt a resolution authorizing one (or more) of its officials, employees, or other designated person to examine the appropriate sales or transactions and use tax records of the Board.

Sections 6066.3 and 6066.4 enable cities and counties to obtain seller's permit application information from retailers desiring to engage in business in their jurisdictions and to submit that information to the BOE. The BOE is required to accept that information as a preliminary application for a seller's permit, and to accept that information also as notice to the BOE for purposes of redistributing local tax under Section 7209. The BOE is required, within 30 days of receiving the local jurisdiction information, to issue a determination regarding the issuance of a sellers permit if that determination can be made on the information provided, or within 120 days in cases where additional information is required.

Proposed Law

This bill would add Section 7054.5 the Revenue and Taxation Code to do the following:

- 1) Authorize any city or county to conduct an examination of the books, papers, records, or equipment of any person selling tangible personal property or any person liable for the use tax within the jurisdiction of the city or county.
- 2) Require the city or county to follow the BOE's audit procedures adopted in its audit manual.
- 3) Provide that a city or county cannot conduct an examination of the books, papers, records, or equipment of a person for any period if any of the following conditions apply:
 - that person has a permit or subpermit for other locations not within the jurisdiction of the city or county;
 - the BOE has notified that person of a pending BOE audit or examination;
 - the BOE is conducting an audit or examination;
 - the BOE has issued either a notice of determination, or a notice that no tax liability was due, to that person within the last five years;
 - the BOE has already audited the same period, or has notified the person that an audit of the same period is pending;
 - the city or county examined the books, papers, records, or equipment of that person within the last three years and no significant additional tax liability was found.
- 4) Provide that a city or county may conduct an examination of any person selling tangible personal property or any person liable for the use tax within the jurisdiction of the city or county, whether or not that person holds a seller's permit or certificate of registration – use tax.

- 5) Authorize a city or county to contract with a private auditing firm to conduct the examination authorized pursuant to this section and in accordance with Section 7056 of the Revenue and Taxation Code.
- 6) Require a city or county upon completing its examination to notify the BOE of its findings and recommendations. Prohibits a city or county from performing any post-examination functions, including but not limited to issuing a determination, hearing a petition, considering a claim for refund, settling a tax liability, or collecting a tax liability.
- 7) Provide that, if the BOE collects sales and use taxes from a person based on the findings and recommendations of the city or county, the BOE shall compensate the city or county in an amount equal to 25 percent of the sales and use taxes collected by the BOE. The BOE shall pay the compensation immediately upon receipt of the sales and use taxes collected pursuant to this section. If a refund is granted in the future, an amount equal to the refund will be deducted from sales tax payments made to that city or county in the same year as the refund is paid.

COMMENTS

1. **Sponsor and purpose.** This bill is sponsored by the City of Long Beach in an effort to generate additional sales tax revenues for cities and counties by auditing those taxpayers that are not correctly reporting their sales taxes. According to the author's office, the City of Long Beach noted in a report prepared by the LAO, Analysis of the 2002-03 Budget Bill, that BOE audits only 3 percent of active registered sellers' accounts each year. According to the author's office, MBIA Muni Services Company (a company that provides technical and support services to local governments and might be one of the companies that would contract with cities to do such audits under the bill) estimates that there is roughly \$6 to \$8 billion per year of unreported sales taxes.
2. **BOE's audit selection process primarily focuses on accounts with the greatest productivity.** BOE's audit selection process selects accounts from all areas of industry. The primary objective is to identify and audit those accounts that experience and other factors indicate are the most likely to have tax understatements due to reporting errors. The audit selection system also groups accounts based on volume and complexity of transactions with each grouping representing a percentage of the tax base. For example, the largest volume and more complex business accounts represent approximately 70 percent of the tax base. So, if 3 percent of the eligible (accounts over a triennium) registered sellers permits are selected for audit, this 3 percent could cover approximately 30 to 40 percent of the tax base. For the fiscal year 2003-04, approximately 2 percent of the active registered sellers' permits were selected covering a total tax base of 32 percent.
3. **BOE's audit program is designed to train auditors on interpreting tax laws correctly and consistently. In order for sales and use taxes to be enforced uniformly, auditors must be properly trained and supervised.** City and county auditors are not experienced in sales and use tax law or audit procedures.

Over the years the BOE has developed an audit program which provides assistance and information to the public, while at the same time, provides a fair and uniform enforcement program that ensures that taxes are reported properly. Part of the BOE's audit program is to train auditors to interpret and apply tax law correctly, as well as train staff in proper auditing procedures and techniques.

BOE has also developed a recruitment plan to identify and hire qualified employees. The majority of BOE auditors are hired through the college campus recruitment program and have obtained a degree in accounting.

The BOE has a wide range of audit and law courses. Newly hired auditors are required to take Basic Sales and Use Tax Auditing (130 hours of course work) and Basic Sales and Use Tax Law (142 hours of course work). Other courses that auditors are required to take include: Audit Comment and Report Writing (20 hours course work), Bar and Restaurant Auditing (10 hours coursework), Construction Contractor Auditing (10 hours course work), Construction Contractor Law (16 hours course work), Statistical Sampling (54 hours course work), Cash Flow Analysis (8 hours course work), Interstate and Foreign Commerce (13 hours course work), Leasing (28 hours course work), Advertising Agencies (28 hours course work), Car Dealer Audits (12 hours course work), Advanced Sales and Use Tax Law review (94 hours of course work), and more.

Experienced staff persons are temporarily assigned to all newly hired auditors to assist them in completing their field audits. Auditors also receive special instructions and guidelines on unusual, complex, or sensitive audit or legal issues. These guidelines are discussed at monthly staff meetings that auditors are required to attend. The BOE also has an extensive performance appraisal and individual development plan designed to evaluate employees' performance and identify training needs.

In summary, the BOE's audit program is designed to give auditors the training and supervision necessary for them to interpret and apply tax laws correctly and uniformly.

City and county auditors are not experienced in sales and use tax law or audit procedures. They do not have an audit training program like the BOE. Without a comparable program, sales and use taxes will not be enforced uniformly. This bill provides for no training or oversight of city or county auditors by the BOE to ensure the proper level of knowledge on the part of the auditors and uniformity of interpretation of the law. Retailers would be subject to differing applications of the law in different parts of the state.

Retailers would be subject to varying interpretations of the law, depending on what auditor was in front of them. While a city or county may not audit a retailer with locations in multiple cities, retailers in the same business in different cities or counties could find themselves facing different tax consequences of their operations depending on how the auditors in their cities or counties interpreted the law. The law could then be seen as arbitrary, and the business climate in California would suffer.

4. **Examinations conducted by cities and counties should not qualify for relief of tax under Section 6596 of the Sales and Use Tax Law.** Section 6596 of the Sales and Use Tax Law provides that taxpayers may be relieved from tax and any penalty or interest charges where they failed to report tax on a transaction because they relied on erroneous written advice from the BOE. Sales and Use Tax Regulation 1705, Relief from Liability, clarifies Section 6596, and provides that, if a prior audit report of a taxpayer contains written evidence that demonstrates the transaction in question was examined, such evidence will be considered “written advice” from the BOE. Audit comments, schedules, and other writings prepared by the BOE which reflect the questioned transaction was properly reported and no amount of tax is due, is sufficient for a finding of relief from liability.

If a city or county conducts an examination, and the work papers reflect that the transaction in question was examined, such evidence could be sufficient for a finding of relief under Section 6596. Since the bill provides for no oversight of the city or county auditors by the BOE (and no funds for the BOE to hire the personnel to perform such oversight even if it was provided), it can be expected that retailers would appeal city or county audits to the BOE for resolution of audit problems. If the BOE Members find that a subsequent city or county or BOE audit made a finding that was not made in a previous city or county audit, whether due to incorrect legal interpretation or inadequate audit methodology, they could find that the taxpayer qualified for relief under Section 6596.

Because city and county auditors are not trained and supervised by the BOE, staff recommends that a provision be added to exclude examinations conducted by cities and counties from relief of tax under Section 6596. Section 7054.5 should be amended to add the following provision:

- (i) The provisions of Section 6596 shall not apply to an examination conducted pursuant to this section.

5. **Cities and counties may not find the tax deficiency they anticipated.** This bill prohibits cities and counties from conducting examinations of taxpayers that hold permits or subpermits for other locations not within the jurisdiction of that city or county. Cities and counties are authorized to conduct examinations of single outlet accounts within their jurisdictions, or multiple outlet accounts as long as all of the locations are within that city or county’s jurisdiction.

Most of the accounts that cities and counties would be examining of are single outlet accounts coded as “SR”. Some of the type of businesses that are coded as “SR” include, liquor stores, bars, small grocery stores, auto repair shops, used car dealerships, and other miscellaneous retail establishments. There are approximately 763,000 “SR” accounts in California. Of these 763,000 accounts, approximately 421,000 are annual filers. To qualify as an annual filer, the taxpayer must have a reported tax liability of less than \$1,200.00 per year. Do cities and counties want to audit accounts with such minimal tax dollars?

6. **Cities and counties would get paid for conducting examinations in an amount equal to 25 percent of all sales and use taxes collected by the BOE**

as a result of that city's or county's examination. What is the basis for the 25 percent compensation? It is not clear how that rate was determined or if it is fair.

Additionally, basing the amount of the compensation on the tax deficiency, could lead to over-aggressive auditing. Also, the compensation rate is based on tax revenue actually collected. If no money is collected, whatever the reason, the city or county receives nothing. Perhaps a different basis for compensation should be considered.

- 7. The compensation amount is vague and needs to be amended.** Subdivision (f) states that the examining city or county is to be compensated in an amount equal to 25 percent of the sales and use taxes collected by the BOE, but the time frame is not set forth. Is the "25 percent" limited to the amount of any deficiency billed or does it include the amount of measure that was originally discovered by the city or county auditor? When a refund is granted, however, the only amount deallocated under the bill, is the exact amount of the refund and not the extra premium which makes up the 25 percent. This last part appears to reward cities or counties for aggressive auditing as they would keep at least a part of the money even if refunds were granted, which would create further negative impacts on California business economy. This phrase needs to be clarified.
- 8. Examinations conducted by cities and counties should be subject to the BOE's audit review process.** BOE has experienced audit staff that reviews audits for correct interpretation and application of the sales and use tax law and authorized rules and regulations of the BOE. Audits are also reviewed for correctness of auditing procedures and techniques, and also verified for any calculation errors. Examinations conducted by city and county auditors should go through the same audit review process as BOE-conducted audits. Any questioned transactions or other types of errors should be returned to the city or county auditor for clarification and/or correction.

Under this bill, the only supervision of the city or county examination that can be made is an appeal to the BOE. This would guarantee numerous appeals, resulting in a clogging of the BOE's appeals process and increased appeals to the Board Members. A concomitant increase in administrative costs to the cities and counties would result, further eroding the revenue gain to the cities and counties.

- 9. This bill precludes the BOE from investigating a tax evader where the city and county has examination.** Subdivision (g) prohibits the BOE from conducting an examination or audit of a person where a city or county has already initiated an examination. The BOE's auditors are trained in recognizing signs of tax evasion. When there is a firm indication of criminal tax evasion, any audit activity is temporarily suspended, and any findings and working papers are referred to the BOE's Investigation Division. The Investigation Division evaluates the account and decides whether or not a criminal investigation should be initiated.

A provision should be added to this bill that will allow the BOE to conduct an investigation, when tax evasion is discovered. BOE staff can work with the author's office in drafting amendments to the bill that would address this issue.

10. Section 7054 currently allows the Board to authorize any person to conduct examinations. Under Section 7054, cities and counties may already make a request to the BOE to conduct examinations. To date, no city or county has ever done so. Perhaps this issue should be addressed first by the BOE, rather than by legislation?

Also, cities are authorized, under Sections 6066.3 and 6066.4, to work with the BOE in making sure that sellers are registered with the BOE. Under Section 7056, cities also have the right to examine BOE records and assist the BOE in determining the correct allocation of local tax monies.

11. Additional technical amendments are needed. Subdivision (b) of the bill lists the various circumstances where a city or county would not be able to conduct an examination. The time frames in subdivision (b)(4) and (b)(6) are inconsistent. Subdivision (b)(4) prohibits a city or county from conducting an examination when the BOE has issued either a notice of determination, or notice that no tax liability was due, to that person within the last five years. Subdivision (b)(6) prohibits a city or county from conducting an examination where another city or county had conducted an examination within the last three years. Also, the language in (b)(6) that reads, “and no significant additional tax liability was found” is too vague. BOE staff is willing to work with the author’s office in drafting amendments to the bill that would address these issues.

COST ESTIMATE

This bill would impact nearly every department at the BOE. The BOE would incur substantial costs related to this bill for notifying retailers, reviewing and processing examinations conducted by cities and counties, processing claims for refund and petitions for redetermination, billing tax deficiencies, processing payments, collection activities, mail processing, answering inquiries from the public, processing appeals to the Board Members, and printing of forms and publications.

A cost estimate of this workload is pending.

REVENUE ESTIMATE

To the extent that cities and counties would conduct examinations resulting in tax deficiencies, there could be some increase in state revenues. However, it is not possible to determine the amount of increase in revenues as a result of examinations conducted by cities and counties.

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